

STATE OF ALABAMA
DEPARTMENT OF INSURANCE
MONTGOMERY, ALABAMA

REPORT ON EXAMINATION

as of

DECEMBER 31, 2001

of

ALFA SPECIALTY INSURANCE
CORPORATION

MONTGOMERY, ALABAMA

PARTICIPATION:

Alabama

EXAMINATION AFFIDAVIT

**STATE OF ALABAMA
COUNTY OF MONTGOMERY**

Rex H. Newborn being first duly sworn, upon his oath deposes and says:

That he is an examiner appointed by the Commissioner of Insurance for the State of Alabama;

That an examination was made of the affairs and financial condition of Alfa Specialty Insurance Corporation for the period of January 1, 1998 through December 31, 2001;

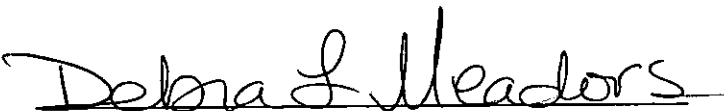
That the following 26 pages constitute the report thereon to the Commissioner of Insurance of the State of Alabama;

And, that the statements, exhibits, and data therein contained are true and correct to the best of his knowledge and belief.



Rex H. Newborn
Examiner-in-charge

Subscribed and sworn to before the undersigned authority this 16th day of July, 2004.



(Signature of Notary Public)

Debra L. Meadors, Notary Public
Printed name

in and for the State of Alabama

My commission expires 7/22/2006

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Montgomery, Alabama
February 20, 2004

Honorable Jose Montemayor
Chairman, Examination Oversight Task Force
Texas Department of Insurance
P.O. Box 149104
Austin, TX 78714-9104

Honorable Alfred W. Gross
Secretary Southeastern Zone
Virginia Bureau of Insurance
P.O. Box 1157
Richmond, Virginia 23218

Honorable Walter A. Bell
Commissioner of Insurance
Alabama Department of Insurance
Post Office Box 303350
Montgomery, Alabama 36130-3350

Dear Commissioner Bell:

Pursuant to your instructions and in compliance with the statutory requirements of the State of Alabama and the resolutions adopted by the National Association of Insurance Commissioners, an examination has been made of the affairs and condition of

**Alfa Specialty Insurance Corporation
Montgomery, Alabama**

as of December 31, 2001, at its home office located at 2108 East South Boulevard, Montgomery, Alabama 36116. The report of examination is submitted herewith.

Where the term, Company, appears herein without qualification, it is synonymous with Alfa Specialty Insurance Corporation.

SCOPE OF EXAMINATION

The examination reported herein covers the period from December 31, 1997 through December 31, 2001, and has been conducted by examiners representing the Alabama Department of Insurance. The Company's insurance affiliates (five property and casualty companies, and one life insurance company) have been examined concurrently with the examination of the Company. Events subsequent to December 31, 2001, have been reviewed as required and are reported herein as deemed appropriate.

The Company has been examined in accordance with the statutory requirements of the Alabama Insurance Code and the regulations and bulletins of the Alabama Department of Insurance; in accordance with the applicable guidelines and procedures of the NAIC; and in accordance with generally accepted examination standards.

The examination included a general review of the Company's operations, administrative practices and compliance with statutes and regulations. Income and disbursement items were tested for selected periods. Assets were verified and valued and all known liabilities were established or estimated as of December 31, 2001, as shown in the financial statements contained herein.

In compliance with requirements of the Alabama Department of Insurance, the President and Treasurer of the Company executed a letter of representation certifying that the Company had valid title to all its reported assets, and that it did not have unreported liabilities as of December 31, 2001.

Within this report, discussion of the Company's accounts has been confined to those items for which a material change in the financial statements has been noted or for which comments and/or recommendations have been made.

ORGANIZATION AND HISTORY

The Company was incorporated on August 11, 1999, as a wholly-owned subsidiary of Alfa Mutual Insurance Company (AMI). The initial marketing plan for the Company, which is also currently in effect, is the writing of non-standard automobile insurance in Alabama, Georgia and Mississippi.

The Company's Articles of Incorporation authorized 10,000,000 shares of common stock of a par value of \$.05 per share and 1,000,000 shares of preferred stock of a par value of \$.10 per share. No preferred stock had been issued as to the date of this examination.

The Company's initial capitalization derived from the issue of 10,000,000 shares of its common stock, to AMI, for a price of \$15,000,000, providing \$500,000 of paid up capital and \$14,500,000 of paid in surplus.

The Company is affiliated with five other property and casualty insurers, which are participants in a reinsurance pooling agreement. The terms of the agreement provide that all direct business of the affiliates will be ceded to AMI. The pooled business is then retroceded according to percentages provided in the pooling agreement. In 1989 an intercompany reinsurance pooling committee, representing the boards of directors of the reinsurance pool participants, was established. This committee is responsible for reviewing and approving any changes to the pooling agreement, to assure that transactions are fair and equitable to all pool participants, and to monitor potential, or actual, conflicts of interest between pool participants. The Company became a participant in the reinsurance pooling agreement in 2001.

On July 23, 2001, the Company's Articles of Incorporation were amended to change the par value of its common stock from \$.05 to \$.10 per share. Subsequent to this action \$500,000 was transferred from paid in surplus to capital. At December 31, 2001, the Company's paid up capital was \$1,000,000, consisting of 10,000,000 shares of common stock of a par value of \$.10. Paid in surplus amounted to \$14,000,000.

GROWTH OF THE COMPANY

The following schedule presents financial data, which reflect the growth of the Company for the years indicated:

<u>Year</u>	<u>Gross Premiums Written</u>	<u>Admitted Assets</u>	<u>Liabilities</u>	<u>Policyholders' Surplus</u>
1999	-0-	15,050,338	149,994	14,900,344
2000	2,023,147	16,300,198	2,014,988	14,285,210
2001	21,361,367	18,628,669	4,733,895	13,894,774

Data for the year 2001 is per examination. Data for the remaining years were obtained from the Company's Annual Statements.

TERRITORY

As of December 31, 2001, the Company was licensed to transact insurance business in the following jurisdictions:

Alabama
Virginia

Georgia

Mississippi

The Certificates of Authority from the respective jurisdictions were inspected and found to be in effect at December 31, 2001.

It was noted that the Company's Certificate of Authority issued by the Alabama Department of Insurance (ALDOI) in 1999, was for casualty business only. In 2001, the Company began assuming reinsurance business from its affiliates through the intercompany reinsurance pool. See the report caption, "Reinsurance," for discussion of the Company's participation in the reinsurance pool. Much of this reinsurance assumed was property business, which the Company was not licensed to write. The Company was advised of this finding, and it applied to the ALDOI for property licensure. The Company's Certificate of Authority was amended April 16, 2003, to license the Company to write property insurance.

STATUTORY DEPOSITS

In compliance with statutory requirements for transacting insurance business in the respective jurisdictions, the Company had the following securities on deposit at December 31, 2001:

Deposits Held for the Benefit of Policyholders, Claimants, and Creditors of the Company

	<u>Par Value</u>	<u>Statement Value</u>	<u>Market Value</u>
<u>Alabama</u>			
Federal Home Loan Bank, 6.73%, due 6/22/09	\$110,000	\$109,860	\$118,319
<u>Georgia</u>			
Wachovia Bank, U.S. Treasury Note, 7.25%, due 5/15/16	35,000	37,433	40,469
<u>Virginia</u>			
Suntrust Bank, U.S. Treasury Note, 7.625%, due 5/15/16	<u>500,000</u>	<u>534,500</u>	<u>578,125</u>

Totals

\$645,000

\$681,792

\$736,913

All statutory deposits were confirmed as of December 31, 2001, by written correspondence with the respective custodians.

HOLDING COMPANY AND AFFILIATES

Holding Company Registration and Reporting

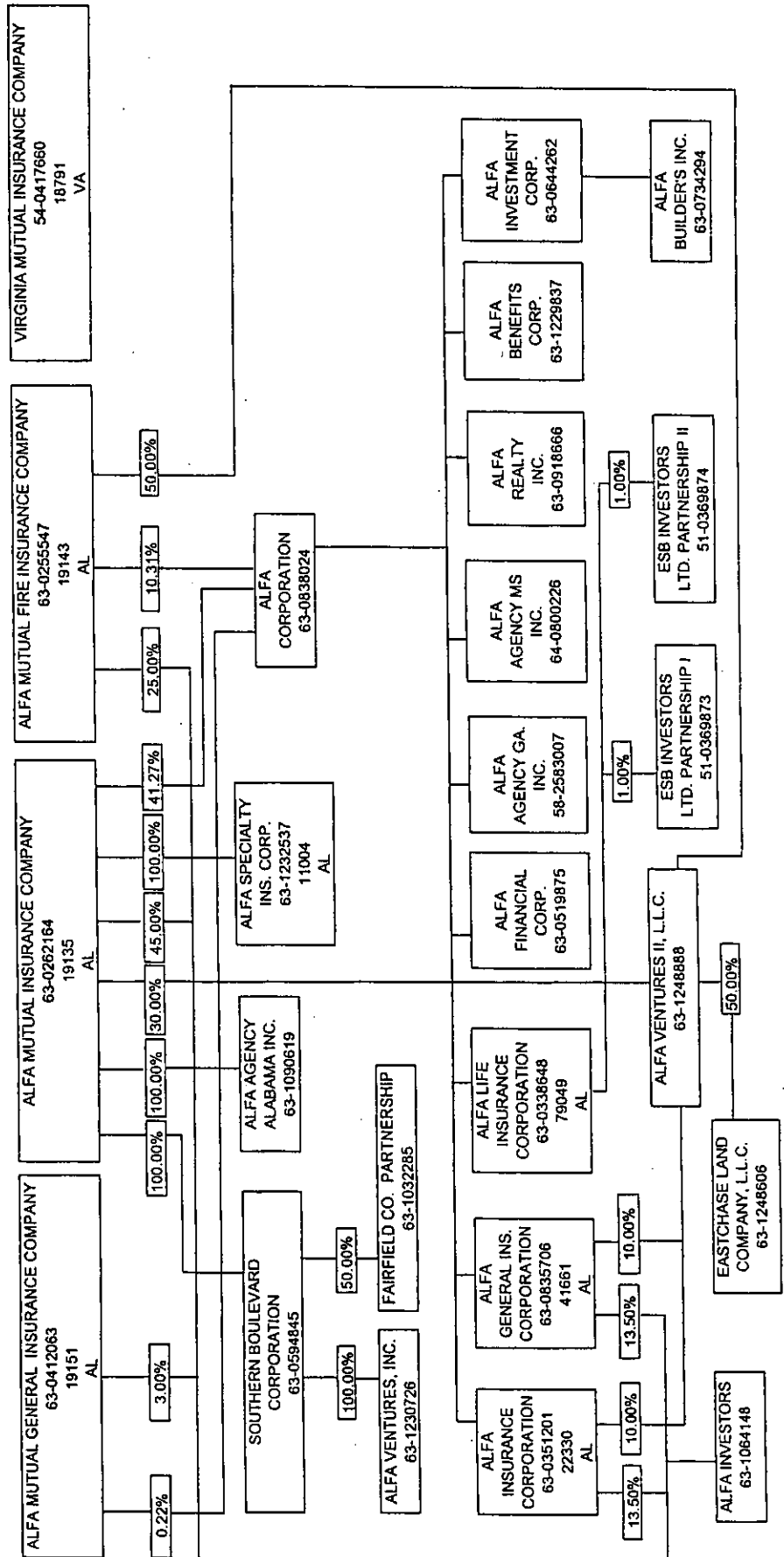
The Company is deemed to be subject to the Alabama Insurance Holding Company Regulatory Act of 1973, as defined in Section 27-29-1, *Code of Alabama*, 1975. The Company is responsible for holding company registration and periodic informational filings with the Alabama Department of Insurance, in accordance with Section 27-29-4, *Code of Alabama*, 1975, and Alabama Department of Insurance *Regulation Number 55*.

Holding Company filings and amendments to registration statements made on behalf of the Company and its affiliates, for the years under examination, were reviewed. Said filings and amendments were found to be substantially complete and to reflect the required disclosures.

Organization Chart

The chart on the following page depicts the insurance holding company system with which the Company was affiliated as of December 31, 2001.

ORGANIZATIONAL CHART



Agreements with Affiliates

Management and Operating Agreement:

The following insurers were under the control of Alfa Mutual Insurance Company (AMI) and were parties to a Management and Operating Agreement with AMI: the Company; Alfa Mutual Fire Insurance Company; Alfa Mutual General Insurance Company; Alfa Insurance Corporation; Alfa General Insurance Corporation; and, Alfa Life Insurance Corporation. These companies will be referred to, collectively, as the "affiliates" in the remainder of the discussion of this topic.

This agreement has been in effect since January 1, 1960, with periodic amendments to modify the terms and to add companies as they became affiliated. Effective January 1, 1990, it was revised to continue on an annual basis through December 31, 2001. After that date, the agreement has been extended for additional periods of one year each.

Pertinent terms of the agreement include the following:

- 1) The affiliates designate AMI to take charge of, conduct, operate and manage the business of the affiliates, respective to each affiliate's charter and Board of Directors, and in a manner conducive to the profitable operation of each respective affiliate. AMI will provide all home office operating services to the affiliates, including accounting, disbursement and payroll services and will serve as a disbursing agent for the payment of all employees and agents of the affiliates.
- 2) AMI agrees to employ, in its own name, all personnel necessary to perform the aforesaid, and reserves all rights and responsibilities of the employer of said personnel. All agents of the affiliates shall be appointed in the name of the respective affiliates and shall work on behalf of the respective affiliates. All personnel and agents of any affiliate employed outside Alabama are the sole responsibility of that affiliate. AMI also agrees to indemnify and hold the affiliates harmless against any loss on account of the dishonesty or infidelity of any AMI employees.
- 3) AMI agrees that the business of each party to the agreement shall be conducted in the name of the respective party and that the records of each party shall be kept separately. AMI Company agrees to provide all required records, record-keeping services and data processing necessary to the efficient and economical operation of such business.
- 4) The affiliates agree to reimburse AMI for expenses and additional charges in accordance with schedules which are attached to the agreement. These schedules are subject to periodic amendment. Expense allocations and

other charges are determined by time, usage, and related special expense allocation studies conducted by AMI. Expenses entirely attributable to the affiliates such as printing and supplies are purchased and paid for directly by the respective affiliate.

Numerous expense categories are prorated between affiliates on Schedule A, an attachment to the agreement. Certain other expenses are allocated directly to the affiliates that benefit from expenditures. Agent's commissions are allocated 100% to the affiliate writing the business. Fixed monthly charges are paid by the affiliate for certain other expenses.

Tax Allocation Agreement:

The Company and certain of its affiliates filed consolidated federal income tax returns during the examination period. The terms of the agreement for allocation of taxes are related in a resolution by the board of directors of the companies that are subject to the agreement. However, no formalized tax allocation agreement among the affiliates has been reduced to writing. Furthermore, the board resolutions do not discuss the settlement of balances between companies. SSAP No. 10, Section 12 c. requires a written income tax allocation agreement, which specifies the terms for settlement of intercompany balances, for recognition of consolidated income tax filings among affiliates.

Dividends to Stockholder

During the period under examination, the Company did not pay any dividends to its sole stockholder, Alfa Mutual Insurance Company.

CORPORATE RECORDS

The Company's Articles of Incorporation, By-Laws and amendments thereto were inspected and found to provide for operation of the Company in accordance with Alabama statutes and regulations and with accepted corporate practices.

Minutes of the meetings of the stockholders, board of directors and committees of the Company, from December 31, 1997 through the most recent meetings recorded at the time of examination, were reviewed. The minutes appeared to be complete and to adequately document the actions of the respective governing bodies.

MANAGEMENT AND CONTROL

Stockholders

Alfa Mutual Insurance Company has been the sole stockholder of the Company from its incorporation in 1999 through the date of this report.

Board of Directors

The Company's By-Laws provide that its property and business shall be managed by a board of directors consisting of eight (8) persons, at least one-third of whom shall be residents of Alabama. Directors are elected at the annual meeting of the stockholder and serve until their successors are elected and qualified.

The following directors were elected by the stockholder and were serving at December 31, 2001:

Director/Residence

Jerry Allen Newby
Athens, Alabama

Stephen Leonard Dunn
Evergreen, Alabama

Hal Franklin Lee
Hartselle, Alabama

James Albert Tolar, Jr.
Marion, Alabama

Russell Riley Wiggins
Andalusia, Alabama

Curtis Dean Wysner
Woodland, Alabama

Principal Occupation

Chairman of the Board, CEO,
and President, Company

Treasurer, Alfa Mutual Companies

Vice President (North Area), Alfa Mutual
Companies

Vice President (Southwest Area), Alfa Mutual
Insurance Company

Vice President (Southeast Area), Alfa Mutual
Insurance Company

Vice President (Central Area), Alfa Mutual
Insurance Company

Officers

The Company's By-Laws provide that its principal officers shall be a chairman of the board, a president, one or more vice presidents, a secretary, a treasurer, and such other officers as the board of directors may determine, and for such terms, authority and duties as may be determined by the appointment. Any two or more offices may be held by the same person, except the offices of president and secretary. Unless otherwise designated, the President will be the CEO.

The following officers were elected by the Board of Directors and were serving at December 31, 2001:

Jerry Allen Newby	Chairman of the Board, President, and CEO
Clyde Lee Ellis III	Vice President and Treasurer
Herman Alan Scott	Secretary

The following officers were appointed by the stockholder and were serving at December 31, 2001:

Clyde Lee Ellis III	Executive Vice President, Operations
Charles Wayne Hawkins	Executive Vice President, Marketing
Stephen Goddard Rutledge	Senior Vice President, CFO & CIO
Herman Alan Scott	Senior Vice President and General Counsel
Jimmy Rogers Azar	Senior Vice President, IA and Planning
John Thomas Jung	Senior Vice President, CIO
James Terry McCollum	Senior Vice President, Claims
Thomas Earle Bryant	Senior Vice President, Human Resources
Jerry Charles Ralph	Senior Vice President, Marketing, North Alabama
William Merit Hardy, Jr.	Senior Vice President, Marketing, South Alabama
Carol Lynn Golsan	Vice President, Marketing Services
Darrell Lee McNeal	Vice President, Georgia Marketing
Robert Wyatt Pace	Vice President, Mississippi Marketing
John Daryl Holley	Vice President and Assistant CFO
David Ray Proctor	Vice President, Taxes
Don Eugene Manis	Vice President, Property Actuary
Christine Gnann Cantrell	Vice President, Marketing Communications
Alfred Edwin Schellhorn	Vice President, Mergers & Acquisitions
Hudson Clayton Bush, Jr.	Vice President, Alfa Agency

Committees

The following committees were appointed by the board of directors and were serving at December 31, 2001:

Pooling Committee

Jerry Allen Newby
Curtis Dean Wisner
James Albert Tolar, Jr.

Conflict of Interest

Conflict of interest statements executed during the examination period were reviewed through 1999. The Company's Policy Statement on Business Ethics and Conflicts of Interest, in effect prior to 2001, required all directors, officers, and employees to execute conflict of interest statements annually. Effective July 18, 2001, the Company adopted a new "Principles of Business Conduct." Because the drafting and adoption of this new policy was in process, there were no conflict of interest statements executed for the year 2000.

The new policy does not require annual conflict of interest statements. It has been amended, February 4, 2003, to incorporate the provisions required by the Federal Sarbanes-Oxley Act. Under the policy, all new employees are required to confirm their compliance with the policy at their hiring. Confirmations are obtained from all existing employees when the policy undergoes significant revision, or whenever circumstances dictate that reconfirmation would be helpful in reinforcing the Company's "tone at the top" message.

FIDELITY BOND AND OTHER INSURANCE

The Company and its affiliates were covered by a fidelity bond through the Fidelity and Deposit Company of Maryland, at December 31, 2001. This policy provided for maximum coverage of \$2,000,000, which was in excess of the \$225,000 amount recommended by NAIC guidelines. Nevertheless, the policy covered twenty-two named insureds which were also affiliates of the Company. The application of the NAIC guidelines based on the assets and income of the Company alone is deemed not to provide an adequate amount of fidelity bond coverage for all the named insureds.

It was deemed to be beyond the scope of the examination to attempt to a consolidation of the assets and income of the subject affiliates in order to arrive at an adequate amount of fidelity bond. The Company has agreed to compute the required amount of fidelity bond, based on a consolidation, and to increase its coverage accordingly.

In addition to the above, the Company had the following coverages in effect at December 31, 2001, under policies issued directly to the Company or as a named insured under policies issued to an affiliate.

- Professional Liability
- Boiler and Machinery
- Commercial Property
- General Liability
- Inland Marine
- Commercial Umbrella
- Worker's Compensation and Employer's Liability
- Business Automobile Insurance

The coverages and limits of the Company's insurance were reviewed and were deemed to adequately protect the Company's interest.

EMPLOYEE AND AGENTS' WELFARE

The Company had no employees of its own during the examination period. Its operations are conducted by personnel employed by Alfa Mutual Insurance Company (AMI), under a management agreement that has been in effect since 1982. All employee and agents benefits for the Alfa Insurance Group are administered by AMI. Costs are allocated to the individual affiliates in accordance with the terms of the agreement.

REINSURANCE

Intercompany Reinsurance Pooling Agreement

This agreement was effective August 1, 1987, between the Alfa Mutual Insurance and its affiliates; Alfa Mutual Fire Insurance Company; Alfa Mutual General Insurance Corporation; Alfa Insurance Corporation; and, Alfa General Insurance Corporation. The Company was added to the pool in 2001. These participants in the pooling agreement will be referred to as "the affiliates" for the remainder of this discussion. This reinsurance pooling agreement was filed with the Alabama Department of Insurance on July 29, 1987, and was subsequently approved. Pertinent terms of the agreement are as follows:

Initially, the affiliates ceded 100% of their book of business then in force to Alfa Mutual Insurance Company (AMI) and paid AMI their proportionate share of the net unearned premium less commissions at the provisional rate of 20%.

Currently, the affiliates cede 100% of the net liabilities for net premiums written to AMI and AMI retains or retrocedes the Pooled business in accordance with the following percentages:

	08/01/87	10/01/94	10/01/96	01/01/01
Company	Pool 1	Pool 2	Pool 3	Pool 4
AMI	32.0	24.0	32.0	18.0
AMF	15.0	8.0	0.0	13.0
AMG	3.0	3.0	3.0	3.0
AGI	25.0	32.5	32.5	32.5
AIC	25.0	32.5	32.5	32.5
ASI (joined pool in 2001)				1.0

Effective November 1, 1996, the affiliates amended the agreement to include catastrophe coverage. The following percentages are shown below for the Coinsurance Allocations for Catastrophe Losses and Related Expenses for the related years:

Effective November 1, 1996			Effective July 1, 1999			Effective January 1, 2001		
Cumulative Calendar Year Catastrophe Losses and Related Expenses	Coinsurance Allocation		Cumulative Calendar Year Catastrophe Losses and Related Expenses	Coinsurance Allocation		Cumulative Calendar Year Catastrophe Losses and Related Expenses	Coinsurance Allocation	
	AGI AIC	AMI AMG		AGI AIC	AMI AMG		AGI AIC	AMI, AMF, AMG, ASI
10	65%	35%	11	65%	35%	11.4	65%	35%
19	0	100%	19	0	100%	19	0	100%
32	0	100%	32	0	100%	32	0	100%
43	0	100%	43	0	100%	43	0	100%
77	0	100%	77	0	100%	77	0	100%
146	0	100%	146	0	100%	146	0	100%
198	0	100%	198	0	100%	198	0	100%
249	13%	87%	249	13%	87%	284	14%	86%
325	13%	87%	325	13%	87%	325	14%	86%
353+	13%	87%	353+	13%	87%	353+	14%	86%

- Cumulative calendar year catastrophe losses and related expenses are in millions.
- AIC and AGI to be allocated equally.
- AMI, AMF, AMG, and ASI to be allocated according to this group's relative pool percentages in effect.
- Catastrophe losses are to be accumulated during each annual calendar period.

Reinsurance Assumed

The Company did not assume reinsurance except through the intercompany reinsurance pool, during the examination period.

Reinsurance Ceded

The Company did not cede reinsurance except through the intercompany reinsurance pool, during the examination period.

MARKET CONDUCT

Plan of Operation

During the period under examination, the Company wrote only non-standard private passenger automobile insurance. During 2001, 70% of its business was written in Alabama, the remaining 30% was split between Georgia and Mississippi. The Company is also licensed in Virginia, but did not write any business there during the examination period.

The Company is represented by 611 captive agents operating from 394 service centers in Alabama, 63 service centers in Georgia, and 62 service centers in Mississippi.

Policy Forms and Underwriting

All the Company's active policy forms and rates in force at December 31, 2001 were found to have been approved by the Alabama Department of Insurance. Rates were filed independently on the Company's direct business.

Membership in the Alabama Farmers Federation was a prerequisite to the issuance of a policy with the Company, for residents of Alabama. The Company's policy is to cancel coverage when Federation membership is not renewed, except on those policies involving a real property lienholder.

Compliance With Agents Licensing Requirements

In order to verify compliance with agents licensing requirements of the Alabama Department of Insurance (ALDOI), a sample of the Company's commission payments was checked against the licensing records of the ALDOI. No discrepancies were found in the sample.

Advertising

The Company's advertising was planned and coordinated by Creative Consultants, Inc, a wholly-owned subsidiary of the Alabama Farmers Federation. The cost of advertising was shared on a proportionate basis with other participating affiliates of the Company and the Alabama Farmers Federation. Various types of advertising were utilized, such as, signs, billboards, newspaper advertisements and spot advertisements on radio and television. The Company also has a Web page (www.alfains.com), which displays the following links: Company's background, product lines, employment opportunities, agent access, how to locate an agent or the Farmers Federation and investing in Alfa stock.

The Company also maintained a cooperative advertising program with its agents. Company sponsored advertising materials were made available to the agents for their advertising purposes. Advertisement costs were shared on a 50/50 basis with the agents when the advertising was approved by the Company and paid invoices were submitted by the agent.

Claims Payments Practices

A sample of open, closed and closed without payment claim files was reviewed in order to evaluate the Company's claims payment practices. Claims were reviewed with regard to compliance with policy provisions, timeliness of payments, and adequacy of documentation.

It was noted that five of the forty-seven claims files chosen for the sample were not available for examination.

Complaints

The files of the Alabama Department of Insurance (ALDOI) were reviewed for complaints against the Company. The overall number of complaints during the examination period was deemed to be low in relation to the amount of the Company's business. However, the Company did not maintain a record of those complaints that were made directly to the Company and not reported to regulatory agencies.

The NAIC Market Conduct Handbook stipulates that a complaint register should include consumer direct complaints as well as those complaints filed with regulatory authorities.

Privacy

The Company's policy is that non-public information involving underwriting, marketing, claims handling and fraud prevention is not shared with anyone outside the Company except for that sharing allowed by the exceptions in the Gramm-Leach-Bliley Act (GLBA). The insured receives a Privacy Notice at the point of sale and the Company sends a Privacy Notice to the insured on an annual basis. The Company appeared to be in compliance with the privacy requirements of Alabama Department of Insurance, *Regulation No. 122*.

ACCOUNTS AND RECORDS

Internal Accounting Records

The Company's internal controls and information systems are those of Alfa Mutual Insurance Company (AMI), since the Company is operated by AMI, in accordance with a "Management and Operating Agreement," among AMI and its affiliates. See "Holding Company and Affiliates," subsection, "Agreements with Affiliates" for details of the agreement. Said internal controls and information systems were reviewed during the concurrent examination of AMI. They appeared to be sufficient to safeguard Company assets and to generate adequate records of its business. The Company's accounting systems and documentation of its transactions were deemed to be adequate.

AMI's internal audit department reports to management, rather than to the Audit Committee of the Board of Directors. Most of the reports generated by internal audit were concerned with agency transactions and service center accounting. Internal audit reports were made available to the examiners, but were of limited use for examination purposes.

External Audit and Actuarial

The Company and its affiliates were audited, on a statutory basis, for each of the years under examination by the certified public accounting firm of KPMG, LLP. The audit reports and work papers of the external auditors were made available to the examiners, and have been utilized in the examination to the extent deemed appropriate.

The Company's reserves were certified, as of December 31, 2001, by Scott Weinstein, FCAS, MAAA of KPMG LLP, of Atlanta, Georgia.

FINANCIAL STATEMENTS

Financial statements included in this report, which reflect the operations of the Company for the years under examination and financial condition at December 31, 2001, consist of the following:

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THE NOTES IMMEDIATELY FOLLOWING THE FINANCIAL STATEMENTS ARE AN INTEGRAL PART THEREOF.

STATEMENT OF ASSETS, LIABILITIES, SURPLUS AND OTHER FUNDS

For the Period Ended December 31, 2001

ASSETS

	<u>Assets</u>	<u>Non-Admitted Assets</u>	<u>Admitted Assets</u>
Bonds	\$ 9,554,756		\$ 9,554,756
Cash	805,680		805,680
Short-term investments	2,245,790		2,245,790
Receivable for securities	5		5
Installment premium plan	455,790		455,790
Premiums in course of collection	5,081,456	\$ 45,406	5,036,050
Guaranty funds receivable	9,527		9,527
Interest, dividends and real estate income	76,986		76,986
Receivable from affiliates	444,085		444,085
Prepaid expenses	698,063	698,063	
Total Assets	<u>\$ 19,372,138</u>	<u>\$ 743,469</u>	<u>\$ 18,628,669</u>

LIABILITIES SURPLUS AND OTHER FUNDS

Liabilities

Losses (<i>Note - 1</i>)	\$ 1,302,268
Loss adjustment expenses (<i>Note - 1</i>)	154,499
Other expenses	119,161
Taxes, licenses and fees	16,505
Unearned premiums	1,748,735
Amounts withheld or retained for account of others	36,752
Drafts outstanding	189,203
Payable to affiliates	771,083
Reserve for premium deficiency (<i>Note - 2</i>)	27,024
Reserve for advance premium	368,665
Total liabilities	<u>\$ 4,733,895</u>

Surplus and Other Funds

Common capital stock	\$ 1,000,000
Gross paid in and contributed surplus	14,000,000
Unassigned funds (deficit) (<i>Note - 3</i>)	<u>(1,105,226)</u>
Surplus as regards policyholders	13,894,774
Total liabilities, surplus and other funds	<u>\$ 18,628,669</u>

STATEMENT OF INCOME

For the Periods Ended,

	December 31, 2001	December 31, 2000	December 31, 1999	December 31, 1998
Underwriting income:				
Premiums earned	\$ 5,765,611	\$ 541,056		
Deductions:				
Losses incurred	\$ 4,850,609	\$ 483,483		
Loss expenses incurred	290,092	27,066		
Other underwriting expenses incurred	1,791,901	1,193,956	\$ 95,711	
Change in premium deficiency	15,751			
Total deductions	\$ 6,948,353	\$ 1,704,505	\$ 95,711	
Net underwriting gain (loss)	\$ (1,182,742)	\$ (1,163,449)	\$ (95,711)	
Investment income:				
Net investment income earned	\$ 813,019	\$ 923,176	\$ 263,664	
Net realized capital gains (losses)	98,035	18,980	-	
Net investment gain (loss)	\$ 911,054	\$ 942,156	\$ 263,664	
Other income:				
Finance and service charges not included in premiums	\$ 81,214	\$ 18,953	-	
Total other income	\$ 81,214	\$ 18,953	\$ -	
Net income before dividends and taxes	\$ (190,474)	\$ (202,340)	\$ 167,953	
Federal income taxes incurred	-	-	55,371	
Net income	\$ (190,474)	\$ (202,340)	\$ 112,582	

N O T I N O P E R A T I O N

RECONCILIATION OF SURPLUS AS REGARDS POLICYHOLDERS

For the Periods Ended December 31,

	<u>2001</u>	<u>2000</u>	<u>1999</u>	<u>1998</u>
				N O T I N O P E R A T I O N
Surplus as regards policyholders, January 1,	\$ 14,285,210	\$ 14,900,344	\$ -	
Net income	\$ (190,474)	\$ (202,340)	\$ 112,582	
Change in non-admitted assets	(121,940)	(409,291)	(212,238)	
Cumulative effect of changes in accounting principles	(11,987)			
Paid in capital			500,000	
Transferred from surplus (stock dividend)	500,000			
Paid in surplus			14,500,000	
Transferred to capital (stock dividend)	(500,000)			
Direct entries to surplus	90			
Adjustment in prior year income tax liability	(66,125)	(3,503)		
Rounding				
Change in surplus as regards policyholders	\$ (390,436)	\$ (615,134)	\$ 14,900,344	
Surplus as regards policyholders, December 31,	\$ 13,894,774	\$ 14,285,210	\$ 14,900,344	

NOTES TO THE FINANCIAL STATEMENTS

<u>Note 1 – Losses</u>	<u>\$1,302,268</u>
<u>Loss Adjustment Expenses</u>	<u>\$ 154,499</u>

The amounts of the captioned liabilities are the same as the amounts reported in the Company's 2001 Annual Statement. However, the amounts per examination differed as follows. The amount of losses determined per examination was \$1,321,000, or \$18,732 more than the amount reported. The amount of Loss Adjustment Expenses (LAE) determined by examination was \$131,000, or \$23,499 less than the amount reported. The total examination difference is \$4,767, and is not material for the purposes of this report. Therefore, no related changes have been made to the financial statements contained herein. These examination differences were developed by the actuarial examiners, and were based on the following findings.

In the opinion of the actuarial examiners, the 2001 Annual Statement reserves were reasonably conservative given the information available at year-end 2001. However, the range of possible outcomes becomes narrower with the passage of time. Given actual development through year-end 2002, it is the opinion of the actuarial examiners that the 2001 Annual Statement reserves are outside the range of reasonable reserves. Therefore, adjustments are recommended for examination purposes. Consistent with the requirements for the statutory actuarial reserves opinion, the examination reserves must be within the range of reasonable reserves defined by the independent actuarial analyses of the actuarial examiners.

Company management explained that the approximate 85th percentile confidence level was targeted at year-end 2001, in order to book reserves at a conservative level. Company management stated that they wished to book reserves at a level where favorable development is more likely than adverse development. SSAP #55, paragraph 10 states that management shall record their best estimate of liabilities for unpaid losses and LAE. Upon detailed review of this guidance, it was determined that the NAIC did not intend this to be a strict guidance. It was determined that reasonably conservative reserve levels should not be specifically prohibited in the consideration of management's best estimate.

It was also the opinion of the actuarial examiners that the reserve redundancy was partially due to the data used to calculate defense and cost containment (DCC) reserves. Both the Company's actuary and the opining actuary relied upon an inconsistent mix of allocated loss adjustment expenses (ALAE) and DCC data in their respective reserve analyses. These actuaries were aware of the inconsistencies and attempted to judgmentally adjust their selections accordingly. In the opinion of the actuarial examiners, those adjustments were subjective. The results of the examination

reserve analyses, which used DCC-only data in the projection of DCC reserves, imply that the booked DCC reserves were conservative.

Note 2 – Premium Deficiency Reserve

\$27,024

The amount of the captioned liability is the same as reported in the Company's 2001 Annual Statement. The actuarial examination of this reserve determined that it was not necessary and that the amount per examination was \$-0-. The difference is not deemed to be material and no related change has been made in the financial statements of this report.

Premium deficiency reserves (PDR) in the aggregate amount of \$1,691,314 were calculated for the participants in the reinsurance pool. The aggregate PDR was allocated to each company based on the pooling percentages (including catastrophe-layer pooling) in effect at year-end 2001. The resulting PDR for the Company was \$27,024. See the report caption "Reinsurance" for details of the Company's participation in the reinsurance pool.

PDR liabilities are relatively rare for insurance companies writing standard personal lines insurance products. Since PDR is a relatively new item in statutory accounting, the Company's actuaries did not have significant historical guidance in establishing the PDR methodology. Therefore, they applied judgment, tempered with conservative assumptions to estimate PDR reserves. The actuarial examiners reviewed the assumptions and provided additional guidance relating to the PDR calculation. Some of the assumptions that contributed to the conservative results are briefly discussed as follows:

- The Company assumed that none of the other acquisition or general expenses are paid at or before policy inception. It is more common to assume that all of other acquisition expenses and a portion of general expenses are paid at or before policy inception.
- The PDR calculation incorporated discounting of losses and LAE for one-half of a year, whereas anticipated incurred losses could be discounted to the expected loss payment date. The discounting calculation assumed that all general expenses and other acquisition expenses are pre-paid. That assumption is inconsistent with the assumption listed above.
- The PDR calculation was conducted separately for each line of business for each direct book of business. The Company should have combined products that are marketed together and combined for profitability analysis. For instance, it is common to assume that auto liability and physical damage products are marketed on a combined basis.

The actuarial examiners conducted independent analyses of PDR, resulting in no indicated liability related to net unearned premiums as of year-end 2001.

Note 3 – Unassigned Funds (deficit)

\$(1,105,226)

The amount of unassigned funds per examination is the same as reported in the Company's 2001 Annual Statement. Variances in account balances determined by the examination were deemed to be immaterial in the aggregate amount.

CONTINGENT LIABILITIES AND PENDING LITIGATION

The examination for contingent liabilities and pending litigation included review of the Company's Annual Statement disclosures, minutes of the corporate governing bodies, pending claims, and the usual examination of the accounts for unrecorded items. No material unreported contingencies were noted and all litigation pending against the Company, at December 31, 2001, appeared to be within the ordinary course of its business.

The Company's Chief Executive Officer and its Chief Financial Officer executed a letter of representation, attesting to the non-existence of unreported liabilities and contingencies as of December 31, 2001.

SUBSEQUENT EVENTS

The review of events subsequent to December 31, 2001 and up to the date of this report included: review of the Company's 2002 Annual Statement; review of cash disbursements through December 31, 2002; review of corporate records through October of 2003; and, inquiries of Company management. No subsequent events were identified that were deemed to have an impact on this examination; and, no subsequent events were identified that might potentially have a material impact on the Company's continued operations and/or financial condition.

COMPLIANCE WITH PREVIOUS RECOMMENDATIONS

The Company has not been previously subjected a full scope examination. The report of Organizational Examination as of November 2, 1999, did not contain any recommendations.

COMMENTS AND RECOMMENDATIONS

Territory – Page 3

The Company was not licensed to write property insurance when it began assuming (property) reinsurance from its affiliates in 2001. The Company's Certificate of Authority was amended April 16, 2003 to license the Company to write property insurance.

Holding Company and Affiliates – Agreements with Affiliates – Page 7

It is recommended that the Company, and the affiliates with which it files consolidated federal income tax returns, develop a written tax allocation agreement, which specifies the terms for the settlement of intercompany balances, in compliance with SSAP No. 10, Section 12 c.

Management and Control – Conflict of Interest – Page 11

The Company's conflict of interest policy was changed during the examination period, and subsequently amended to add the requirements of the Federal Sarbannes-Oxley Act. Annual reporting requirements have been eliminated under the new policy.

Fidelity Bond and Other Insurance – Page 11

The Company's fidelity bond coverage was found to be inadequate to cover the Company and twenty-two affiliates that are named insured on the policy. The Company has agreed to compute the required amount of coverage based on a consolidation of the assets and income of all the named insureds, and increase its coverage accordingly.

It is noted that the examination of the Company as of December 31, 1997 also found the amount of the Company's fidelity bond to be inadequate.

Market Conduct – Claims Payment Practices – Page 15

It is recommended that the Company maintain complete and accurate records with regard to its claims files, in accordance with Section 27-27-29, *Code of Alabama*, 1975.

Market Conduct – Complaints – Page 15

It is recommended that the Company maintain a complaints register that includes all complaints received, rather than just those that are filed with regulatory agencies.

Losses & Loss Adjustment Expenses – Page 21

The loss and LAE reserves reported in the Company's 2001 Annual Statement were found to meet the requirements of SSAP #55, at the time said reserves were reported. Based on development through year-end 2002, said reserves were not within a reasonable range; however, the differences were not deemed to be material and no related changes have been made in the financial statements of this report.

Premium Deficiency Reserve – Page 22

The Company's PDR liability has been adjusted to zero for examination purposes. It is recommended that the Company re-evaluate its PDR calculations and assumptions for future analyses, and statutory reporting purposes.

CONCLUSION

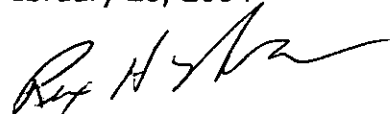
Acknowledgement is hereby made of the courtesy and cooperation extended by representatives of **Alfa Specialty Insurance Corporation** during this examination.

The customary examination procedures, as recommended by the National Association of Insurance Commissioners, have been followed to the extent appropriate in connection with the verification and valuation of assets and the determination of liabilities set forth in this report.

Examination findings indicated that the Company was in sound financial condition as of December 31, 2001.

In addition to the undersigned, the following persons represented the Alabama Department of Insurance as participants in this examination: Palmer W. Nelson, AFE, Douglas T. Brown, Thomas W. Salo, Theophilos C. Goodin, Deanne Brown, Larae Mason and Bobby Mckinnon, examiners; Glenn Taylor, ACAS, MAAA, and Randall D. Ross, actuarial consultants.

Respectfully submitted,
February 20, 2004



Rex H. Newborn, CFE
Examiner-in-Charge
Alabama Department of Insurance

EXAMINER'S AFFIDAVIT AS TO STANDARDS AND PROCEDURES
USED IN AN EXAMINATION


STATE OF ALABAMA

COUNTY OF MONTGOMERY

Jack M. Brown, being duly sworn, states as follows:

1. I have authority to represent the State of Alabama in the examination of Alfa Specialty Insurance Corporation, Montgomery, Alabama.
2. The Alabama Department of Insurance is accredited under the National Association of Insurance Commissioners Financial Regulation Accreditation Standards.
3. I have reviewed the examination workpapers and examination report, and the December 31, 2001 examination of Alfa Specialty Insurance Corporation, Montgomery, Alabama was performed in a manner consistent with the standards and procedures required by the State of Alabama Department of Insurance, and the National Association of Insurance Commissioners.

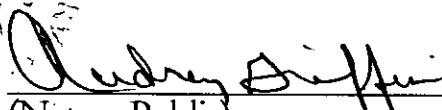
The affiant says nothing further.



Jack M. Brown, CFE, CIE
Assistant Chief Examiner, and Insurance Examinations Supervisor
State of Alabama, Department of Insurance

Subscribed and sworn before me by Jack M. Brown, on this 16th day of July, 2004.

(SEAL)



(Notary Public) My commission expires 11/2/05
(Date)